
FRBSF WEEKLY LETTER

July 24, 1987

Are Bank Loans Special?

Recent innovations in financial markets, such as the growth of asset securitization and the deregulation of depository institutions, have raised new questions concerning the role of commercial banks in the economy. Much of the present system of bank regulation is based on the premise that banks are special, i.e., that they provide a unique service or set of services for which no close substitutes are provided by other financial institutions. If banks indeed were special, then the way in which they are special would have important implications for bank regulation as well as the conduct of monetary policy.

This *Letter* examines the arguments as to why banks might be special and discusses the evidence on whether bank loans are special. The public policy implications associated with whether banks are special are also discussed.

Traditional view

The traditional view of the role of banks in the economy focuses on their role in the payments system. Banks are special, the argument goes, because, unlike other financial institutions, they provide transactions services by taking in demand deposits. This involvement in the money supply process has been the basis for regulations, such as reserve requirements, designed to facilitate monetary control and for regulations directed at bank safety and soundness. The latter set of regulations is intended to prevent bank failures and runs, which, if they were to become widespread, could threaten the payments system.

This focus on the role of banks in the payments system is reflected in a recent proposal calling for the separation of bank lending activities from the provision of transaction services. The proposal would require the establishment of a bank subsidiary or an entirely separate entity to offer checking accounts. In addition, checking accounts would be subject to a 100 percent reserve requirement (which could be met with

marketable, interest-bearing securities). Commercial loans could be made only by banks or their subsidiaries not offering demand deposits.

The intent of this proposal is to provide a completely safe payments system (a system without the possibility of bank failure) without the need for deposit insurance. This so-called "safe depository" proposal is based on the premise that, while there is something special about deposit-taking, there is nothing special about bank loans.

Unique features of bank assets

An alternative view is that banks are special at least in part because of their lending activity. The uniqueness of their role lies in the information gathering and monitoring process associated with commercial lending. Specifically, banks have a comparative cost advantage in information gathering and monitoring relative to other financial institutions. This comparative advantage arises, in part, from banks' ongoing deposit history with the borrower. The inside information provided by this ongoing relationship with a depositor/borrower is especially useful in the short-term repeat lending activity in which banks specialize. Moreover, an ongoing relationship is particularly valuable for small business borrowers that would find it uneconomical to generate the type of information needed for public securities offerings.

Two facts tend to support this view. First, banks often require that borrowers maintain compensating balances (i.e., have a deposit account at the lending institution). This suggests that the bank and its borrower view a deposit account as an integral part of the lending relation. Second, commercial banks are the dominant supplier of short-term debt, particularly to smaller corporate borrowers. At year-end 1986, commercial banks held \$541 billion in commercial and industrial loans, most of which have a maturity of one year or less. The next largest source of short-term financing is the commercial paper market with

FRBSF

\$79 billion in paper issued by industrial firms outstanding. The commercial paper market is limited however to relatively large, well-known borrowers.

The important role of banks in the information gathering process has led to a distinction between "inside" and "outside" debt. Inside debt is defined as a loan for which the lender has access to information about an organization not otherwise publicly available. Outside debt, in contrast, is defined as a publicly traded claim, for which the security holder relies on publicly available information generated, for example, by security analysts and auditors. Publicly traded bonds, equities (stocks), and commercial paper are examples of outside securities. Bank loans are an example of inside debt.

Implications

If bank loans were special, then several important public policy implications would follow. First, regulatory policy motivated solely by a concern over the role of banks in the payments system may impose serious costs on the economy. For example, the proposal discussed earlier for separating bank lending and checking account services may disrupt the supply of bank loans. If there were important synergies in deposit-taking and lending, then cost savings could be lost, increasing the cost of commercial bank loans. This increase in the cost of intermediation services could result in a decrease in investment activity.

A second implication of the view that bank loans are special is that widespread bank failures may have serious macroeconomic consequences beyond their effect on the money supply or the payments system. Specifically, if banks were an important part of the financial infrastructure because of their lending activities, then widespread failures could close an important conduit of funds to borrowers and result in a decline in the amount of investment.

Finally, the proposal to separate bank lending from deposit-taking activities would not provide financial stability if bank loans were unique. Protection of the payments system, which the proposal affords, only addresses a part of the problem presented by bank failures. Ensuring financial stability also involves avoiding disruptions in the credit intermediation process, in which banks play a critical role. As long as banks invest primarily in nonmarketable and

illiquid commercial loans while funding themselves with more liquid deposits, the potential for bank runs will continue to exist.

A recent study of the banking failures of 1930-1933 by Ben Bernanke suggests that banks play a unique role in credit markets. He finds that bank failures during the period raised the real cost of borrowing, particularly to small, less creditworthy firms that did not have access to "outside" sources of debt. His analysis suggests that the disruption to the intermediation process caused by the bank failures of the 1930s contributed significantly to the decline in economic activity during the period.

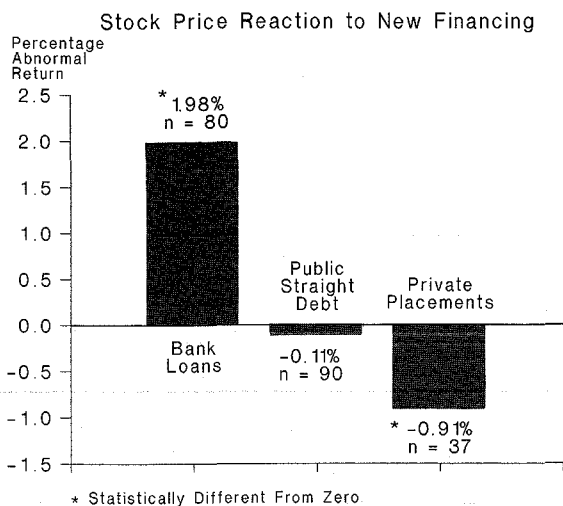
Evidence from the stock market

Some evidence (albeit indirect) on whether bank loans are special can be found by examining the stock price response of borrowing firms around the announcement date of new bank loan agreements and public securities offerings. Several studies have found a significant decrease in the value of a firm's common stock around announcements of public offerings of debt and equity.

One explanation for this finding is that a corporation's managers have information about the firm's future prospects that outside investors do not. Therefore, firms tend to issue new securities when they perceive they are *overvalued* by the market. In contrast, firms with new investment opportunities of which outsiders are unaware, or firms with opportunities that are costly to convey to outsiders in an accurate or reliable fashion (since all firms have an incentive to overstate the profitability of new projects), will find themselves *undervalued* in the market. These firms will be reluctant to issue new public securities because these securities would be underpriced. Therefore, they may pass up valuable investment opportunities.

Bank loans as a form of inside debt provide a possible solution to the problem of information asymmetries associated with public securities offerings. Banks, having better information about the firm's prospects than outsiders, presumably would price their loans to reflect the true prospects of the firm. If this conjecture were correct, one would expect to observe a rise in the stock price of the borrowing firm in reaction to the announcement of new bank loans.

A related reason an appreciation of a firm's stock may result in response to the announcement of new bank loans is that the loan approval process itself may convey information to market partici-



pants about the financial strength of the firm. Loan renewals or new extensions provide a credible "seal of approval" concerning the firm's future prospects. This seal of approval implies that other claimants of the firm need not undertake similar costly evaluations of the firm's financial condition.

To examine the stock price reaction to the announcement of new bank loans as well as other debt offerings, a sample was constructed of all announcements of public straight debt offerings, private placements of debt with non-bank institutions (primarily insurance companies), and new commercial bank loans for 300 randomly selected firms. The sample consisted of all announcements of new debt offerings and bank loan agreements by these firms over the period 1973 through 1983. For each financing event, the percentage change in the borrowing firm's stock price was computed around the announcement date. The price change was adjusted for the stock's expected price behavior based on general movements in the market to provide an estimate of the abnormal return attributable to the financing announcement.

As the chart indicates, there is a positive (1.98 percent) stock price reaction to the announcement of new bank loan agreements. In contrast, there is a small negative price reaction for public straight debt offerings. This finding is consistent with the hypothesis that bank loans are special because they are a form of inside debt.

Of particular interest is the difference between the stock price reaction to bank loans and private placements of debt. If a positive stock price response to bank loan announcements were representative of some benefit associated with borrowing through a financial intermediary, we would expect to see a similar price reaction for private placements made through insurance companies. However, as the chart indicates, the price reaction to announcements of private placements is negative (and the difference in price response between bank loans and private placements is statistically significant). This result suggests that bank loans are special relative to loans made by other financial institutions, such as insurance companies, possibly because of the information generated from a deposit relation a bank has with a borrower.

Additional evidence

An additional piece of evidence on the question of whether bank loans are special, comes from the market for bank-issued large certificates of deposits (CDs). These deposits are currently subject to a 3 percent reserve requirement, which acts like a tax to raise the cost of these funds to banks. A recent study found that bank CD holders do not appear to "pay" the tax in the form of lower yields. In particular, when reserve requirements were increased in the late 1970s, CD yields did not fall relative to yields on other money market instruments, as would be the case if CD holders shared the burden of increased reserve requirements. The lack of change in CD yields suggests that the reserve tax is shifted to bank borrowers in the form of higher loan rates. This could occur, however, only if bank loans had no close substitutes, i.e., if they were unique.

Conclusion

A critical question in the debate over how bank regulation should be structured is whether there is anything special or unique about commercial banks. Evidence from the stock market and the market for bank CDs suggests that bank loans are unique. Thus, when making regulatory changes, policymakers should consider the consequences for the cost and availability of bank credit as well as for the payments system.

Christopher James

Opinions expressed in this newsletter do not necessarily reflect the views of the management of the Federal Reserve Bank of San Francisco, or of the Board of Governors of the Federal Reserve System.

Editorial comments may be addressed to the editor (Gregory Tong) or to the author Free copies of Federal Reserve publications can be obtained from the Public Information Department, Federal Reserve Bank of San Francisco, P.O. Box 7702, San Francisco 94120. Phone (415) 974-2246.

Alaska Arizona California Hawaii Idaho
Nevada Oregon Utah Washington

Research Department Federal Reserve Bank of San Francisco

BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 7/1/87	Change from 6/24/87	Change from Dollar 7/2/86	Percent ⁷
Loans, Leases and Investments ^{1 2}	206,975	1,583	4,002	2.0
Loans and Leases ^{1 6}	184,016	1,727	2,236	1.1
Commercial and Industrial	53,147	474	1,241	2.3
Real estate	69,516	259	2,675	3.7
Loans to Individuals	36,685	— 8	— 4,446	— 10.8
Leases	5,405	9	— 116	— 2.1
U.S. Treasury and Agency Securities ²	16,034	168	5,331	49.8
Other Securities ²	6,924	— 311	— 444	— 6.0
Total Deposits	214,619	11,148	3,610	1.7
Demand Deposits	60,073	9,875	4,137	7.3
Demand Deposits Adjusted ³	39,896	4,795	— 11,549	— 22.4
Other Transaction Balances ⁴	19,859	949	3,397	20.6
Total Non-Transaction Balances ⁶	134,687	325	— 3,923	— 2.8
Money Market Deposit Accounts—Total	44,604	211	— 2,506	— 5.3
Time Deposits in Amounts of \$100,000 or more	31,726	— 537	— 4,590	— 12.6
Other Liabilities for Borrowed Money ⁵	23,995	— 147	— 383	— 1.5
Two Week Averages of Daily Figures	Period ended 6/29/87	Period ended 6/15/87		
Reserve Position, All Reporting Banks				
Excess Reserves (+)/Deficiency (—)	217	51		
Borrowings	18	8		
Net free reserves (+)/Net borrowed(—)	199	44		

¹ Includes loss reserves, unearned income, excludes interbank loans

² Excludes trading account securities

³ Excludes U.S. government and depository institution deposits and cash items

⁴ ATS, NOW, Super NOW and savings accounts with telephone transfers

⁵ Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources

⁶ Includes items not shown separately

⁷ Annualized percent change